The Achievements and Challenges of European Union Financial Integration and Its Implications for the United States

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The views expressed in this paper are those of the author and do not necessarily represent the views of the Group of Thirty.

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I. Introduction

I have been asked to approach this complex subject—the achievements and challenges of European Union (EU) financial integration and its implications for the United States—from a broad perspective. I shall thus not deal with technical points, and will instead focus on several macro considerations that can help the reader better understand some particular and important aspects of the subject.

I will address three themes:

1. The importance of the European market in financial services. This has become a major pillar of international finance and compares favorably with the other large markets of the world.

2. However, the present level of integration of financial markets in Europe remains inadequate. How can the development of European global players be enhanced?

3. What are the implications of European Union financial integration for the United States?

II. The Importance of the European Union Financial Market

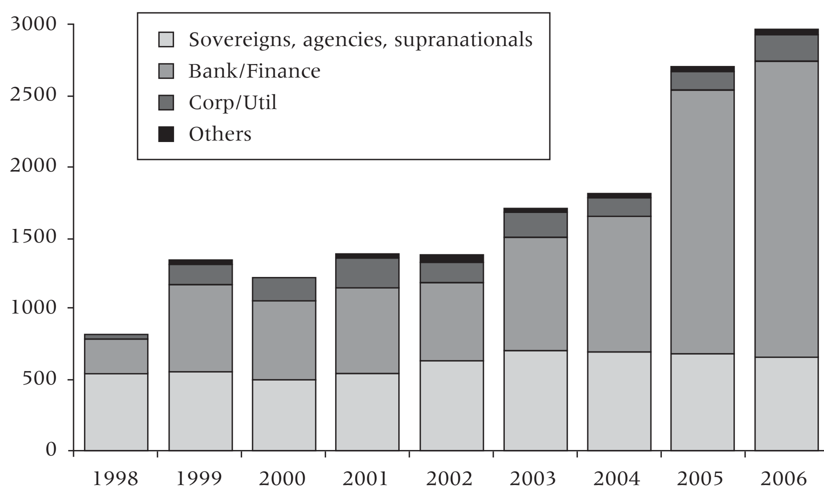
The European financial market compares favorably with the other large markets of the world, in particular with the financial market of the United States. This is especially evident in the bond markets.

A. Bond Markets

1. The new issues in gross terms of EU bonds (of more than two-year maturity) denominated in euros have increased considerably since the creation of the euro (1998: 800 million euros, 2005: 2.7 billion euros [see Figure 1 and Table 1]).

FIGURE 1. EUR[1] BOND ISSUANCES, 1998–2006 (DOMESTIC + INTERNATIONAL MARKETS)

(in millions of euros)



Source: Dealogic Bondware.

2. The market of bonds issued in euros represents about 60 percent of the U.S. dollar market. Since 1999, the new issues of bonds in euros amounted to 14.9 billion euros compared to 25.7 billion euros for bonds issued in U.S. dollars (see Figure 2) (BNP Paribas Bondware).

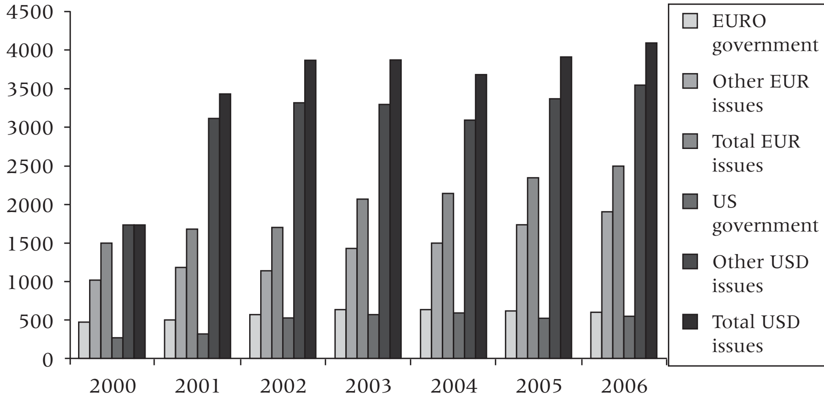
TABLE 1. GROSS ISSUANCES GOVERNMENT COMPARED TO NONGOVERNMENT INTERNATIONAL + DOMESTIC, EUR-USD, MATURITIES > 2 YEARS

	Billions Euros	Domestic + international							
EUR bn	1998	1999	2000	2001	2002	2003	2004	2005	2006
EURO government	518.0	528.7	477.2	500.6	573.1	638.5	633.4	612.0	592.0
Other EUR issues	668.9	1102.5	1020.8	1174.0	1132.2	1432.2	1508.6	1731.5	1906.8
Total EUR issues	1186.9	1631.2	1498.0	1674.6	1705.3	2070.7	2141.9	2343.5	2498.8
US government	377.0	311.4	263.0	328.7	528.8	566.7	591.5	533.0	541.0
Other USD issues	1591.5	1664.6	1726.7	3108.9	3327.2	3291.8	3084.8	3368.8	3547.6
Total USD issues	1968.5	1976.0	1989.7	3437.6	3856.0	3858.4	3676.3	3901.8	4088.6

Source: BNP Paribas; Bondware.

1 Note : All references in the paper to 'EUR' refer to the Euro, the currency of the European Union.

FIGURE 2. GROSS ISSUANCES, IN BILLION EUROS, EUR-USD, GOVERNMENT AND NONGOVERNMENT (INTERNATIONAL + DOMESTIC MARKETS), MATURITY > 2 YEARS



Source: Dealogic Bondware; BNP Paribas Bondware.

3. Given that the role of banks in the financing of the economy is much more important structurally in Europe than it is in the United States (although this is slowly changing), it is more significant to consider the *international role, respectively, of the euro and of the dollar*. When one adds up the bonds issued by "nonresident" companies, by foreign governments, and by the multilateral institutions on external markets (that is, in markets outside the countries or the monetary zones where these issuers are headquartered), one observes that the issues of this type in euros represented from 1999 to the end of 2006 a cumulative amount practically equal to that of the comparable issues in dollars (5.1 billion euros compared to 5.7 billion euros).[2]

4. Moreover, if one adds to the figures above, which concern only bonds of more than two years' maturity, the short-term bond issues and issues on money markets, the net total issues in euros represented 54.9 percent of the global world market in 2005. The figure for dollar issuances of the same types is only 26.4 percent of the market (see Table 2).

2 By adding to these "international" issues those of the "domestic" governments (of the Eurozone and the United States, respectively), the cumulative numbers show that the market in euros exceeds that of the dollar (since 1999: 9.9 billion euros compared to 9.6 billion euros) (BNPParibas Bondware).

TABLE 2. NET ISSUANCE, GROSS ISSUANCE AND OUTSTANDING IN THE INTERNATIONAL BOND AND NOTE MARKETS (%OF WORLD TOTAL)

	Net Issuance							
	1999	2000	2001	2002	2003	2004	2005	Q1-06
Dollar	46.8%	50.7%	49.4%	43.2%	32.1%	23.9%	26.4%	34.2%
Euro	45.9%	39.0%	43.7%	49.1%	56.3%	59.6%	54.9%	49.6%
Yen	-0.7%	1.1%	1.3%	1.7%	0.3%	1.7%	0.2%	-0.3%
Other	8.0%	9.2%	5.6%	6.0%	11.3%	14.8%	18.5%	16.5%
	Gross Issuance							
Dollar	43.9%	46.5%	49.1%	46.9%	40.6%	34.8%	34.3%	37.3%
Euro	38.4%	34.1%	36.5%	38.4%	44.6%	48.5%	47.9%	46.5%
Yen	6.7%	7.6%	5.4%	4.2%	3.6%	3.4%	3.0%	2.0%
Other	11.0%	11.8%	9.0%	10.5%	11.2%	13.3%	14.8%	14.2%
	Outstanding							
Dollar	47.0%	49.1%	50.8%	46.2%	40.5%	36.9%	38.5%	37.8%
Euro	28.8%	30.2%	32.2%	37.5%	43.5%	46.8%	45.2%	46.0%
Yen	10.4%	8.3%	5.8%	4.9%	4.4%	4.0%	3.4%	3.2%
Other	13.7%	12.4%	11.2%	11.3%	11.6%	12.3%	12.9%	13.0%

Source: BIS, October 2006

The above figures show that the euro market has increased considerably since the beginning of 2000 and that it today constitutes for all corporations and governments of the world a vast, sure, and liquid source of funds, of a size now greater than that of the dollar.

Of course, the dollar remains dominant as an international reserve currency—65 percent of international official reserves compared to 24 percent for the euro. The bond markets create a bipolar financial world where the euro plays the leading role.[3]

B. The Equity Markets

In contrast to the dynamic changes seen in the bond markets, Euro equity markets remain significantly smaller than the U.S. equity markets.

3 In terms of average unit amount by issue, statistics show that in 2006 the average for the euro exceeded 500 million euros compared to 300 million for issues in dollars, and 400 million for issues in pounds sterling.

In terms of market capitalization, the Eurozone represented in 2005 16.8 percent of the global world capitalization, the U.S. share represented 41.6 percent, and the Japanese share represented 11.1 percent (see Table 3.)

TABLE 3. MARKET CAPITALIZATION WORLDWIDE; AVERAGE CAPITALIZATION AS PERCENTAGE OF WORLD

	World	U.S.A.	Eurozone	Japan
2002	100.00	47.5	16.1	10.4
2003	100.00	46.2	16.1	10.5
2004	100.00	43.7	16.4	11.2
2005	100.00	41.6	16.8	11.1

Source: BNP Paribas.

In terms of market capitalization related to the gross domestic product (GDP) of the countries and monetary zones concerned, the Eurozone equity market represented 55 percent in 2005 (compared to 42.7 percent in 2003), while the United States represented 105.24 percent and Japan 84.9 percent (see Table 4).

TABLE 4. MARKET CAPITALIZATION WORLDWIDE, AVERAGE MARKET CAPITALIZATION AS A PERCENTAGE OF NOMINAL GDP PER COUNTRY

	World	U.S.A.	Eurozone	Japan
2002	67.9	99.4	53.2	57.1
2003	61.8	94.0	44.0	54.5
2004	70.6	105.3	49.9	68.0
2005		105.24	55.0	84.9

Source: BNP Paribas.

As for the volume of share transactions (“turnover”), Europe represented in 2006 26 percent of the global total and the United States represented 49 percent (*Financial Market Trends*).

Furthermore, the share of equity in the investment funds held by “Europe 25” households has increased by 3 percentage points since 2002 and amounted to 26.5 percent in 2005, while the same share in the United States remained stable at 45 percent.[4]

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4 *L'Observatoire de l'Epargne Européenne.*

Based on the above it is clear that the Eurozone equity market is still significantly smaller than that of the United States.

C. Financial Services

A recent study[5] shows that while Europe has certain fields where it still lags behind the United States (including managed funds, returns from investment banks, share transactions, hedge funds, private banking), the gap between the two markets is narrowing as European financial service providers continue to innovate. This period of "catch up" has been evident since 2001.

A few data points worth considering are:

- As regards insurance (life and non-life): the premiums received by European companies have exceeded those of their American counterparts since 2003 (1.3 trillion dollars for the former compared to 1.1 trillion dollars for the latter in 2005).[6]

- As regards banks, three findings are significant:

  1. Revenues generated on average by a European customer of investment banks represent 71 percent of those of the American customer.

  2. The assets of European commercial banks (42 trillion dollars) represent nearly four times those of their American counterparts (11 trillion dollars).

  3. The outstanding amount of international (non-domestic) loans granted by European banks amounted, at the end of 2005, to 14 trillion dollars compared to 1.9 trillion dollars for American banks. If we subtract, the intra-European business from their international activities, it still appears that the external lending position of European banks vis-à-vis the rest of the world is three times the U.S. figure.[7]

5 *Financial Market Trends*, "Europe vs. U.S.," International Finance Services, London, 2006.
6 Ibid.
7 Ibid.

These figures demonstrate the worldwide importance of European financial services markets and the competitiveness of the global European financial players in an increasingly integrated world. In certain financial service areas European players are dominant, while in others the United States has an edge. So it is appropriate to ask: "What are the challenges to better integrate European markets and to facilitate the global expansion of these European players?"

III. The Inadequate Level of Integration of Financial Markets in Europe

A. The Present Situation

There are three significant elements:

1. While the bond markets, money markets, and wholesale banking business in Europe are already well integrated, with the European Union's "Prospectus Directive" constituting a rather effective base,[8] this is not the case for retail financial activities, which are constrained by different national regulations, most notably as regards consumer protection.

2. The level of integration also suffers because Europe is characterized by a fragmentation of its market infrastructures. This is true of national stock exchanges, one of which was bought by American operators rather than collaborating to create a truly Europe-wide market infrastructure.

Similar national challenges afflict aspects of Europe's clearing and settlement systems, despite the efforts of the European Union, national

8 For details of the prospectus Directive, see http://ec.europa.eu/internal_market/securities/prospectus/index_en.htm.

regulators, and market participants to build a more efficient framework. The Group of Thirty has been especially engaged in this endeavor.[9]

3. Finally, Europe has very diverse regulations and supervisory systems, notwithstanding efforts by the European Commission to improve matters. The "Lamfalussy process"[10] was intended to bring more coordination and homogeneity both at the level of the national transposition of the European Union's Directives and at the level of the implementation of supervision. Unfortunately, differences in national regulatory structures and forms of implementation are still significant.

Despite the considerable harmonization achieved in recent years within the framework of the Financial Services Action Plan (FSAP) and Directives undertaken by the European Commission,[11] the European market of these services has not yet become a true "single" market. The creation of the euro has helped move the process forward. However, the euro cannot reach its full economic potential until the FSAP is a success and European financial markets become fully and effectively integrated.

B. How Do We Progress?

Before trying to answer this question, it is useful to recall what is at stake economically for consumers in the European Union.

The continued fragmentation of the retail financial services sector in Europe means that European consumers cannot yet take advantage of a vast supply of pension-related products, and of more secure and cheaper services that can be offered by larger entities based on unified platforms. For example, at present European investment funds are five times smaller than that of their American equivalents. If European funds

9 "Post-trading" activities are essential for the competitiveness of financial markets in Europe: the (avoidable) costs linked to the fragmentation of the clearing and settlement infrastructures are considerable (2 to 5 billion euro a year according to recent studies). For more detail, see the Group of Thirty's "Final Monitoring Report: Global Clearing and Settlements," published in 2006.

10 On February 15, 2001, the European Commission's Committee of Wise Men on the Regulation of European Securities Markets, which was chaired by Baron Alexandre Lamfalussy, completed its work. The recommendations contained in the report and the process of implementing them via Community legislation is generally known as the "Lamfalussy process." For more details on the process, see http://ec.europa.eu/internal_market/securities/lamfalussy/index_en.htm.

11 For more details on the Financial Services Action Plan, see http://ec.europa.eu/internal_market/finances/actionplan/index_en.htm.

were of the scale seen in the United States, as a result of cross-border mergers, this would tend to significantly reduce management costs and risk volatility.

In summary, despite the increasing consistency among the members of the European Union in terms of general regulatory orientation, national peculiarities and regulatory differences remain the rule when it comes to transposition of European standards into national law.

There is an additional consideration: the complexity and heterogeneousness of prudential and surveillance regulations. These differences in national supervisory architecture penalize not only those firms that are striving to deepen their cross-border business relationships in Europe—it is often almost as difficult to expand business from one European country to another than to achieve the same objective elsewhere in the developed industrialized world—but also can undermine or hamper the global expansion of the largest financial players of our continent.

Two approaches to this problem are possible, and they should be combined:

1. The classic approach toward harmonization: that is, the adoption of identical rules and regulations across markets. This approach is obviously useful to pursue while acknowledging that progress is not easy. Indeed, at the heart of this approach are very difficult political, cultural, and business issues including: the politically sensitive issues of consumer protection; the structural diversity of behaviors as regards payments (that is, use of checks and methods of payments culturally preferred in different member states); and the legally complex issue of harmonizing bankruptcy rules, contracts, and company laws, not to mention taxation and other issues.

Given this, the European Commission, rather than proposing a new arsenal of directives, has focused on several priorities, notably:

- The constitution of a Single European Payment Area (SEPA);[12]
- A limited number of financial products (consumer credit, mortgages, and the Understanding for Collective Investment in Transferable (UCIT) Securities);[13]

12 SEPA is being pursued in collaboration with the European Central Bank. See http://www.ecb.int/paym/pol/sepa/html/index.en.html.

13 For more information on the UCIT, see http://ec.europa.eu/internal_market/securities/ucits/index_en.htm.

- A code of good conduct for "post-trading" activities;
- The elimination of additional and superfluous provisions at the time of the transposition of the Directives into national law.

The above makes eminently good sense and can foster the European market of financial services. But these steps do not answer all the challenges and problems addressed earlier. It is thus necessary to combine these efforts with another approach.

2. An approach consisting of strengthening the large European financial players to allow them to develop not only on a European but also on a global scale.

This is where issues of regulation and supervision are most important.

European financial services taken as a whole, whether they relate to banks, to insurance companies, or to the management of assets, are facing fierce global competition. European financial services companies are confronted with common problems: rapid technological evolution; an increasing number of mergers; the creation of cross-sector behemoths; and the emergence of new markets (China and India, most notably), where new financial "giants" are appearing.

To build a single financial Europe, it is necessary to favor competitiveness by offering, on a European scale, a legal status that will facilitate mergers between players, whatever their nature: mutualist, cooperative, or commercial. In other words, Europe has to establish a solid base for financial players so they can operate on the international stage and strengthen their positions as global institutions.

In this respect, regulation and supervision play a major role. Well designed and applied consistently, effective regulation and supervision can facilitate this evolution. But if the regulatory structures are too fragmented, too complex, or too onerous, they can, on the contrary, slow the growth and internationalization of these firms. We should avoid hampering this necessary expansion, and address the continuing unnecessary complexities of our regulatory and supervisory systems, which are today too fragmented.

The stakes are high and the questions we must answer in this process are very important. What are the methods that would allow a homogeneous implementation of the regulatory requirements? How do we assess the quality and relevance of the internal risk assessment models

in order to rationalize the new capital requirements without excessive rigidity and useless complexity? What do we mean by the concept of a "lead supervisor" and is such a system effective? What do we think of the recent and innovative proposal of the British Treasury tending to create a "lead supervisor" for insurance companies groups?

All this deserves reflection, an open mind, and a climate of confidence among political decisionmakers, European and national supervisors, and financial institutions. The key to building this indispensable level of trust lies in the definition and the sharing of a common vision of the impact of evolving financial techniques, of risk modelling, and of the system processes to be implemented in case of crisis, all this to take place in a more and more globalized economy and changing world.

EUROFI[14] proposed in June 2006 that a body of public decision-makers and representatives of the industry engage in an open discussion on these thorny and difficult questions. I hope that this dialogue, which is ongoing among industry players in 2007, will eventually succeed.

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14 EUROFI "Banking and Finance in Europe" is a leading financial services think tank. For more details, see http://www.eurofi.net/.

IV. Implications for the United States

A. U.S. Financial Institutions Are Thriving in Europe

The rapidly developing European financial market has attracted U.S. financial institutions that are playing an increasing role in mergers and acquisitions, offering structured products and developing investment funds. The recent acquisition of the Euronext stock exchange platform by New York Stock Exchange is an illustration of this trend.

In 2005, among the 10 top banks involved in European mergers and acquisitions, U.S. banks have been advisers on more than 65 percent of the deals.

In 2006, looking at the five largest investment banking deal winners in France, four have been U.S. international banks (accounting for 60 percent of the number of deals and 76 percent of the totals involved).[15]

The thrust of the strategy of U.S. banks in Europe is to develop their fee-generating business from their existing structures. In contrast, European banks have been investing heavily in acquisitions in the United States.[16]

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15 1. BNP Paribas: 108 billion euros (63 operations).
2. Goldman Sachs: 98 billion euros (24 operations).
3. Merrill Lynch: 93 billion euros (23 operations).
4. Morgan Stanley: 87 billion euros (28 operations).
5. Citigroup: 77 billion euros (23 operations).
(Source: F*usion et Acquisitions* magazine.)

16 From 2001 to 2006, American banks acquired 865 million U.S. dollars in the financial sector of the European Union (27). During the same period European banks acquired 62.9 billion U.S. dollars in the U.S. financial sector. (Source: Bloomberg.)

B. Regulatory and Supervisory Conditions

In the integrated world, regulatory and supervisory conditions have a major influence in shaping competition. In this respect, the equity markets in the United States have recently lost a good deal of their attraction, notably because of new U.S. regulatory constraints. While these markets drove approximately 50 percent of all the initial public offerings (IPOs) during the 1990s, this percentage fell to 6 percent in 2005 (24 of the 25 largest IPOs took place in 2006 outside the United States, most of them in London).

This sudden fall can be explained by:

- The vitality and efficiency of European and emerging capital markets (see Aim, for example, in London);
- The new U.S. regulatory requirements (the average cost of section 404 of the Sarbanes-Oxley Act amounted in 2004, its first year of implementation, to 4.3 million dollars per company);
- The rising importance of private capital markets (private equity issues are practically free from mandated disclosure requirements);
- The high listing costs of the New York Stock Exchange compared with those of large non-U.S. markets; and
- The reluctance of foreign companies that consider being listed in the United States to do so because they worry about the difficulties of delisting should that ever be desirable.[17]

Conversely, a simpler and more coherent regulatory and prudential setting in Europe will help not only European but also U.S. financial institutions.

C. Regulatory and Supervisory Constraints

It is essential that basic regulatory and supervisory constraints be compatible on both sides of the atlantic. There have been significant steps forward in this respect:

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17 See "Interim Report of the Committee on Capital Markets Regulation," by Glen Hubbard, John Thornston, and Hal Scott, November 30, 2006; and the McKinsey Report, "Sustaining New York's and the U.S. Global Financial Services Leadership."

- The new international financial reporting standards (IFRS)—although far from perfect—are at least leading to the harmonization of accounting and auditing rules for listed companies. But there is still work to do on mutual recognition equivalence and the removal of reconciliation requirements for IFRS and U.S. generally accepted accounting principles.

- Under the strong leadership of the United States, Basle II has modernized and refined capital adequacy requirements and has insisted on improving risk management. Europe has adopted the Accord in the form of a legislative directive. However, it is in the United States that application problems are now arising. It is important and urgent that U.S. regulators—who appear more fragmented in this respect than their European counterparts—allow their international banks to abide by this new set of rules and principles so that there can be an orderly and synchronized implementation of the Accord on a consolidated basis.

- In terms of securities, a dialogue is underway between the EU and the United States that I hope will lead to a more level transatlantic playing field. In this regard, it is encouraging to note the recent amendment passed by the Securities and Exchange Commission (SEC) on March 21, 2007, concerning de-registration. This amendment would significantly facilitate de-registration by foreign firms (the SEC has estimated that about 60 percent of European companies could de-register).[18] This goes some way toward addressing one of the key complaints of the Hubbard report.

- Regarding insurance supervision, Europe is developing a modern system (Solvency II) based on internal risk assessments which, if adequately designed, could become a model for international regulators in this field.

18 De-registration had not been authorized for foreign companies having 300 or more U.S. shareholders! Now a company can de-register if it can show that the average daily U.S. trading volume of its shares has been no greater than 5 percent of its global trading volume over the previous 12 months.

V. Conclusion

In an integrated world where capital moves freely and where competition for capital is increasing, it makes good sense for the regulators of the "two pillars" of the financial system to work together on an equal footing so they can develop consistent rules, share their best practices, promote fair competition, and avoid regulatory arbitrage and extraterritorial temptations.

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